

Office of Chief Counsel
Internal Revenue Service

memorandum

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MJCalabrese

date: April 23, 2002

to: Percy Weathington, Revenue Agent and
Dennis Leonardi, Financial Products Specialist

from: Associate Area Counsel (LMSB), Chicago

subject: Opinion - Tax consequences of debt-like straddle security

Taxpayer: [REDACTED]

This memorandum responds to your office's ongoing request for assistance on this taxpayer. We are coordinating this matter with Financial Products Industry Counsel Rose Gole and Thomas Kerrigan. This memorandum should not be cited as precedent.

ISSUES

1. Whether [REDACTED] ([REDACTED]) may deduct the [REDACTED] "interest" payments it made to holders of [REDACTED] units, where the [REDACTED] constituted a financial product with the principal amount at issuance and the redemption amount at maturity relating to the value of the common stock of [REDACTED] (a corporation unrelated to the taxpayer).

2. Are [REDACTED]'s [REDACTED] and holdings of [REDACTED] common stock part of a straddle subject to the capitalization rules of I.R.C. § 263(g).

CONCLUSIONS

1. [REDACTED] may not deduct the [REDACTED] "interest" payments it made to holders of [REDACTED].

2. [REDACTED]'s [REDACTED] and holdings of [REDACTED] common stock are part of a straddle subject to the capitalization rules of I.R.C. § 263(g).

FACTS

Prior to [REDACTED], [REDACTED] held [REDACTED] and [REDACTED] as wholly owned subsidiaries. On or about [REDACTED], [REDACTED] sold the subsidiaries to [REDACTED] ([REDACTED]). As a result of this sale and certain related transactions, [REDACTED] acquired [REDACTED] shares of [REDACTED] common stock.

[REDACTED]

[REDACTED]

The Exchange Rate made a [REDACTED] unit payable at maturity on a scale that depended upon the "Maturity Price" of the [REDACTED] stock. "Maturity Price" was defined generally as the average per share closing price of [REDACTED] common stock for the 20 trading days prior to the maturity date. If the Maturity Price of [REDACTED] common stock was equal to or less than \$ [REDACTED], one [REDACTED] was exchangeable for one share of [REDACTED] common stock. If the Maturity Price of [REDACTED] stock was more than \$ [REDACTED] but less than \$ [REDACTED], one [REDACTED] would exchange for a fractional share of [REDACTED] stock having a value of \$ [REDACTED]. If the Maturity Price of [REDACTED] stock was \$ [REDACTED] or greater one [REDACTED] would exchange [REDACTED] shares of [REDACTED] common stock.

[REDACTED] was not restricted in its ability to sell, pledge, or otherwise convey its holdings of [REDACTED] stock. The [REDACTED] obligation was unsecured, ranking on a parity with [REDACTED]'s unsecured and unsubordinated indebtedness. In the event of [REDACTED]'s insolvency and liquidation, the holders of the [REDACTED] had no priority claim to the [REDACTED] stock.

The [REDACTED] supplement to the prospectus states that

_____ and _____ holders were contractually required to characterize the _____ for tax purposes as a forward purchase contract to purchase _____ common stock at the _____'s maturity. Amounts paid for the _____ units were to be treated as cash deposits to assure _____ holders' purchase obligations. The _____% interest payments were to be treated as compensation for _____'s use of the deposits. At maturity of the _____, the deposits were to be treated as applied by _____ to the _____ holder's forward purchase contract obligations.

Default for 30 days in payment of any interest, nonpayment of principal at maturity or upon acceleration, and certain other events result in an Event of Default. Upon an Event of Default, either the trustee or holders of at least _____% of the outstanding _____ units may declare all principal and accrued interest to be immediately due and payable. After a declaration of acceleration but prior to the trustee obtaining a judgment or decree for payment, the holders of a majority of the _____ may under certain circumstances rescind and annul the acceleration.

_____ acquired _____ in _____. For purposes of the _____ units, approximately _____ shares of _____ common stock were substituted for each share of _____ common stock. The terms of the _____ otherwise stayed the same.

_____ treated the _____ obligation as debt. It took interest deductions of \$ _____ and \$ _____ for the years _____ and _____. _____ also deducted amortized amounts of underwriting and other costs.

ANALYSIS

The _____ issuance allowed _____ to raise a sizeable amount of cash in _____. It also provided _____ with downside protection with regard to its holdings of _____ common stock. _____ issued the _____ units in a principal amount equal to the \$ _____ price of _____ common stock. If _____ years later the stock dropped in price, _____ could

exchange each [REDACTED] unit in the principal amount of \$ [REDACTED] with stock having a lesser value. The [REDACTED] issuance also allowed [REDACTED] to fully benefit from any increase in value of the [REDACTED] stock up to any price per share less than \$ [REDACTED]. If the stock appreciated to a per share price of \$ [REDACTED] or more, [REDACTED] and the [REDACTED] holder would share in a percentage of the appreciation.

1. Characterization of the [REDACTED] as debt, equity, part debt and part equity, or something that is neither debt nor equity

- a. Under I.R.C. § 385(c), [REDACTED], but not the Service, is required to treat the [REDACTED] as debt**

In enacting I.R.C. § 385, Congress authorized the Treasury Secretary to prescribe regulations for determining whether an interest in a corporation constitutes debt, equity, or something that is part debt and part equity. However, no regulations under § 385 now exist. I.R.C. § 385(c) states that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)."

In this case [REDACTED] (the issuer) characterized the [REDACTED] as debt. This characterization of the [REDACTED] as debt is binding on [REDACTED], though not the Service. I.R.C. § 385(c)(1). The Service may analyze the facts and circumstances of the [REDACTED] issuance to determine whether [REDACTED] properly characterized the [REDACTED] as debt.

- b. An analysis of the facts and circumstances shows that the [REDACTED] units lack sufficient elements to be treated as either debt or equity**

Whether an obligation constitutes debt or equity is a question of both fact and law. In the Matter of Larson, 862 F.2d 112 (7th Cir. 1988). Determining the existence of a bona fide indebtedness depends upon the particular facts of the case. In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. Various courts have considered different tests and relevant factors; however, "in the final analysis . . . the question depends on the facts and circumstances of each case". Kean v. Commissioner, 91 T.C. 575 (1988). Assessing the various factors "may often be difficult because it is the result of adding and weighing several elements of a situation some of which may give rise to conflicting inferences." Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).

Not all factors may apply in a particular case. Courts generally have said that the question of genuine debt does not turn on any one factor. In reviewing certain corporate obligations, called "income debenture bearer bonds" in one case and "registered notes" in another, the Supreme Court in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) said that "[t]here is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts." See also Saviano v. Commissioner, 765 F.2d 643, 649 (7th Cir. 1985) (no one characteristic is "decisive in the determination of whether the obligations are risk investments in the corporations or debts"); Smith v. Commissioner, 370 F.2d 178, 180 (6th Cir. 1966) ("[n]o single factor is controlling"); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905 (7th Cir. 1959) (in determining whether certain payments constituted debt or equity, "no single test can provide the answer"); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Brazoria County Stewart Food Markets v. Commissioner, T.C. Memo. 2001-220. Sometimes a court will say that the question rarely turns on one factor. See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957) ("[r]arely should any one element be determinative").

Courts have identified a number of relevant factors in making a debt or equity determination. In Notice 94-47, 1994-1 CB 357, the Service gave notice that it would scrutinize financial instruments characterized as debt for federal tax purposes and characterized as equity for regulatory, rating agency, or financial accounting purposes. The Notice described some of the relevant factors it would consider:

(a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

In Notice 94-47 the Service recognizes that no factor conclusively establishes debt or equity and that the weight given to any particular factor depends upon the facts and circumstances. See also John Kelly Co. v. Commissioner, 326 U.S. 521 (1946); Dixie Dairies Corporation v. Commissioner, 74 T.C. 476 (1980). The Service will take account of the overall effect of the financial product's debt and equity features.

An analysis is usually used to determine whether a transaction created debt or equity. Here, though the [REDACTED] units clearly do not constitute equity, we cannot say that by default they constitute debt. The following analysis of the Notice 94-47 factors examines whether the [REDACTED] units are properly characterized as debt.

(a) An important indication of debt is an unconditional promise on the part of the obligor to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). The lack of a maturity date on a financial instrument constitutes strong evidence of equity. Wood Preserving Corporation v. United States, 347 F.2d 117, 119 (4th Cir. 1965); United States v. Title Guarantee and Trust Co., 133 F.2d 990 (6th Cir. 1943); Rev. Rul. 90-27, 1990-1 CB 50. In this case, the [REDACTED] had a fixed maturity date [REDACTED] years after issuance. [REDACTED] had an unconditional promise to exchange [REDACTED] stock (or pay an equivalent amount) on that date. To this extent, the factor suggests debt. However, [REDACTED] had no obligation to pay a fixed dollar amount at maturity. Instead, [REDACTED]'s payment depended upon the Maturity Price of [REDACTED] common stock. If the Maturity Price of [REDACTED] had no value, [REDACTED] had no obligation to pay anything of value in exchange for the [REDACTED].

Generally, a creditor expects that at maturity the debtor will repay the principal amount originally loaned by the creditor. Here the [REDACTED] holder takes a significant risk that it will be repaid less than the principal amount, and some risk that it will be repaid with nothing of value. Equity stakeholders traditionally assume such risks. Also, as with a shareholder, a [REDACTED] holder has an opportunity to receive more than the [REDACTED] original principal amount. The [REDACTED] holder receives such a "premium" if the [REDACTED]'s Maturity Price is \$[REDACTED] or greater.

(b) A right to enforce payment of principal and interest suggests debt. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Here, the holders of the [REDACTED] had certain enforcement rights. An event of default allowed the trustee or holders of at least [REDACTED]% of the [REDACTED] to declare all principal and accrued

interest immediately due. Holders of more than [REDACTED] of the [REDACTED] could annul the acceleration. Thus, a minority of [REDACTED] holders wanting default acceleration are subject to an ultimate decision by the majority. Though the formal enforcement rights contain some limitations, they are generally consistent with those of bondholders. Unlike a bondholder, however, a [REDACTED] holder has no right to enforce payment of the original principal amount. The [REDACTED] do not provide for the fixed repayment of the original principal amount. As such, this factor suggests something other than debt.

(c) A creditor may have a claim subordinate to other creditors. Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2nd Cir. 1956). Still, subordination may suggest equity when combined with other equity factors. Trans-Atlantic Company v. Commissioner, 469 F.2d 1189 (3rd Cir. 1972); Rev. Rul. 83-98, 1983-2 CB 40. Here, like a credit interest and unlike an equity interest, the rights of [REDACTED] holders was unsubordinated as to [REDACTED]'s other claimants. To this extent the factor suggests debt. However, in some sense, and with respect to the payment of principal at maturity, the holders of the [REDACTED] were subordinated to [REDACTED]'s creditors¹. If [REDACTED] became worthless and liquidated, asset distributions would have gone to [REDACTED]'s creditors, while the value of the stock would have dropped to [REDACTED]. This aspect of the factor, when combined with other equity factors, might suggest that the [REDACTED] holders had some sort of an equity interest in [REDACTED].

(d) The ability of the security holder to participate in management is a factor suggesting equity. Gloucester Ice & Cold Storage v. Commissioner, 298 F.2d 183 (1st Cir. 1962) rev'g T.C. Memo. 1960-195. In this case, the [REDACTED] indenture did not provide for any real rights of management participation, a factor characteristic of debt.

(e) A shareholder's advance is more likely to be treated as equity when the corporation is thinly or inadequately capitalized. Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984), aff'g T.C. Memo. 1982-314; Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969). [REDACTED] is a large, publicly traded corporation. We know of no facts showing it to be thinly capitalized.

¹ With respect to the payment of interest, [REDACTED] holders depended upon the financial health of [REDACTED] only, as it is our understanding that a financially capable [REDACTED] would still make interest payments should [REDACTED] have become valueless.

(f) A factor suggesting equity may exist where the shareholder and the financial product holder are the same. Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Tampa & Gulf Coast Railroad Co. v. Commissioner, 56 T.C. 1393 (1971). Here, [REDACTED] is a large, publicly traded corporation. The [REDACTED] units were publicly issued; they were not developed for [REDACTED]'s shareholders. We have no reason to believe that the [REDACTED] holders were the same as the shareholders. This factor, which looks at the identity of the shareholders and [REDACTED] holders, does not support an equity determination, and it is consistent with a debt determination.

(g) [REDACTED]



(h) Treating an obligation as debt for tax purposes and equity for other purposes gives rise to questions as to the true nature of the financial product. Here, the facts do not indicate that [REDACTED] treated the [REDACTED] as equity for nontax purposes.

Here, the [REDACTED] have little indication of equity. None of the debt-equity factors strongly suggest equity in [REDACTED]. The [REDACTED] interest provides the holder with a possible future right to [REDACTED] stock, not [REDACTED] stock. Payment to the [REDACTED]

holders does not depend upon [REDACTED]'s earnings or financial performance. The [REDACTED] holders have no management rights, no voting rights, and no rights to convert the [REDACTED] into [REDACTED] stock. A [REDACTED] interest does not provide the holder with an equity interest in [REDACTED].

Though not equity, a [REDACTED] is not necessarily debt. A number of the [REDACTED] factors that score in favor of debt really do so by default when the factor scores against equity (if its not an equity factor, it generally is consistent with an indebtedness characterization).

In this case, a number of the Notice 94-47 factors are characteristic of debt. The [REDACTED] interest does not give holders a right to participate in [REDACTED] management. [REDACTED] presumably was not thinly capitalized. No identity of interest between shareholders and [REDACTED] holders exists. [REDACTED] labeled the [REDACTED] as a debt instrument and, as far as we know, treated it as a debt instrument for nontax purposes.

Two of the Notice 94-47 factors on the surface look like debt, though considered analysis shows that the facts and circumstances contain elements inconsistent with indebtedness. With regard to factor (b), the [REDACTED] holders, with some limitations, have a right to enforce payment, thereby suggesting debt. However, the [REDACTED] holders do not necessarily have any right to enforce payment of the original principal amount of the [REDACTED] issuance, a fact inconsistent with traditional rights of creditors. With respect to factor (c), the rights of [REDACTED] holders are unsubordinated as to [REDACTED]'s creditors (a fact consistent with debt), though they are effectively subordinated to [REDACTED]'s creditors (a fact inconsistent with debt).

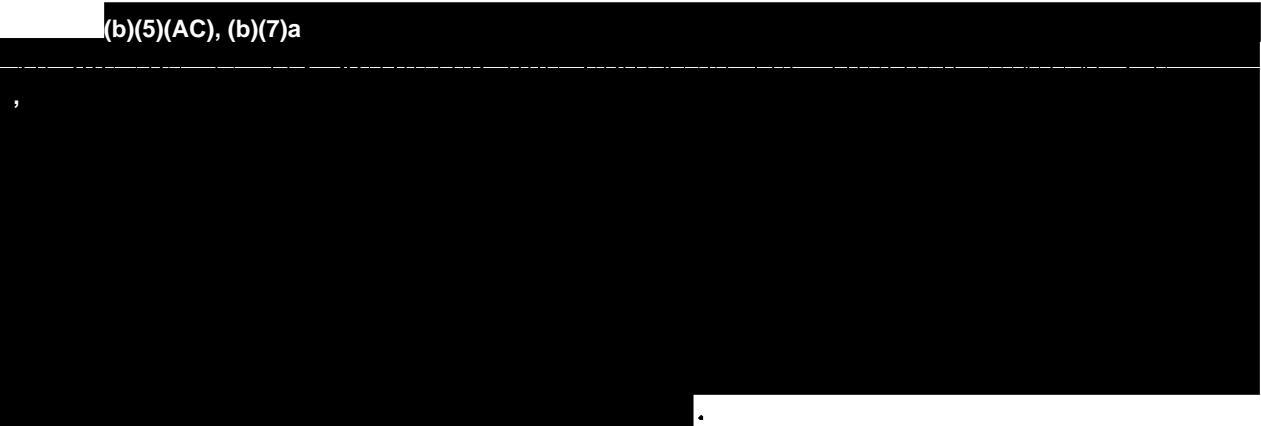
Notice 94-47 factor (a) works strongest against a debt determination. [REDACTED] unconditionally promised to pay a sum (in accordance with a formula) on a fixed maturity date [REDACTED] years after issuance; however, the amount to be paid was not a sum certain. Payment at maturity was contingent upon the Maturity Price of [REDACTED] stock. If [REDACTED] had become worthless, the [REDACTED] holders, at maturity, would have had no right to receive anything of value. In some situations debt may involve a contingent payment at maturity². However, in this case, being effectively subordinated to [REDACTED]'s creditors and assuming a risk of nonpayment on an instrument with terms that no traditional creditor would accept, indicates that the

² Treas. Reg. 1.1275-4 discusses the accrual of original issue discount on contingent debt instruments.

██████ holders hold something other than debt.

The situation is unusual in that the ██████ holder's interest is neither debt nor equity. In I.R.C. § 385 Congress recognized at times it is necessary to determine whether an interest in a corporation should be treated "as stock or indebtedness (or in part stock and in part indebtedness)." We believe that an interest in a corporation may also be neither debt nor equity. For example, under these facts (or a slight modification thereof) the interest of the ██████ holders might more properly be characterized as a contract right to acquire and succeed to ██████'s equity interest in ██████. In any event, the facts here are insufficient to establish the ██████ interest as indebtedness. As such, ██████'s quarterly payments to the ██████ holders do not constitute deductible interest payments.

(b)(5)(AC), (b)(7)a



2. The facts of the case involve a straddle subject to the capitalization rules of I.R.C. § 263(g)

I.R.C. § 263(g)(1) denies a deduction "for interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in section 1092(c))." Any such amounts not allowable as a deduction are chargeable to the capital account with respect to the personal property to which the amounts relate. I.R.C. § 263(g)(1).

a. The facts of the case involve a § 1092(c) straddle

I.R.C. § 1092(c)(1) defines "straddle" as "offsetting positions with respect to personal property." A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property (whether or not of the same kind). I.R.C. § 1092(c)(2)(A).

For straddle purposes "personal property" is defined in § 1092(d)(1) as any personal property of a type which is actively traded. In general, stock is excluded from the definition of personal property. I.R.C. § 1092(d)(3)(A). I.R.C. § 1092(d)(3)(B) describes three situations where this rule does not apply. Two of the exceptions apply to any stock that is part of a straddle in which at least one of the offsetting positions is (1) an option with respect to that stock or substantially similar stock or securities, or (2) as provided in regulations, a position with respect to substantially similar or related property (other than stock). I.R.C. § 1092(d)(3)(B)(i)(I) and (III).

██████████ has a long position in the equity of ██████████, the common stock of which is referenced by the ██████████. The issuance of the ██████████ resulted in a straddle if one of the § 1092(d)(3)(B) exceptions applies to ██████████'s situation.

i. Treating the ██████████ transaction as a cash settlement collar

The Service determined in Rev. Rul. 88-31, 1988-1 C.B. 302, that § 1092's straddle rules covered a situation where a taxpayer held publicly traded stock and cash settlement contingent payment rights relating to that stock. A corporation issued, and the taxpayer held, investment units consisting of one common share and a separately tradeable contingent payment right, the value of which varied inversely with the market value of the underlying common stock. The contingent payment would be made to the holder two years after the issuance date of the right. The Service determined that the contingent payment and the common stock were separate property rights. The contingent payment right constituted a cash settlement put option under § 1234(c)(2). As an option with respect to the stock, I.R.C. § 1092(d)(3)(B)(i)(I) excepts the option right from the rule that "personal property" as used in § 1092 does not include stock.

In ██████████'s case, the ██████████ may be viewed as essentially constituting a combination of ██████████ purchasing a put option and writing a call option that will be exercised at different strike prices (a cash settlement collar)³. As such, ██████████'s interest

³ ██████████ has taken a position analogous to an investor taking a "short" position in ██████████ common stock; it is in a situation analogous to that of a holder of a put option. ██████████ sold each ██████████ unit for \$██████████. Terms of the ██████████ were such that if, upon the maturing of the ██████████, the price of ██████████ stock was below \$██████████ (even if the value of the

in [REDACTED] stock would constitute § 1092 "personal property". I.R.C. § 1092(d)(3)(B)(i)(I). Provided the two positions are offsetting, [REDACTED]'s position in the [REDACTED] and [REDACTED] common stock constitutes a straddle.

The contingent payment right described in Rev. Rul. 88-31 was a short position that substantially diminished the risk of loss from decline in value of the underlying common stock. Holding both the contingent payment right and the stock constituted a § 1092 straddle.

[REDACTED] had a long position in [REDACTED] stock by owning [REDACTED] shares of its common stock. By issuing the [REDACTED] units, [REDACTED] took a short position in [REDACTED]'s stock. Exercising the "put" embedded in the [REDACTED] protects [REDACTED] from a decline in the value of the [REDACTED] stock. [REDACTED]'s risk of loss from having written the call option embedded in the [REDACTED] is substantially diminished by holding [REDACTED] common stock. The facts and consequences follow those in Rev. Rul. 88-31. [REDACTED]'s offsetting position in the [REDACTED] substantially diminished [REDACTED]'s risk of loss from holding the long position in [REDACTED] common stock. [REDACTED]'s holding [REDACTED] stock reduced its downside risk from issuing the [REDACTED]. By issuing the [REDACTED], [REDACTED] entered into a straddle.

ii. Treating the [REDACTED] transaction as other than a collar

The [REDACTED] may also be analyzed as a single financial product. The [REDACTED] may be viewed as a type of notional principal contract. Tres. Reg. 1.446-3(c)(1)(i) describes a notional principal

stock dropped to below the \$[REDACTED] issue price), [REDACTED] needed only to give the [REDACTED] holder [REDACTED] of [REDACTED] stock (or an equivalent amount of cash). As a holder of a "put option-like" right embedded in the [REDACTED], [REDACTED] effectively had the right to sell [REDACTED] stock at the strike price of \$[REDACTED]. (In the typical put option case, the holder of the put option receives the strike price only at the time the put is exercised rather than when the option is first created. Also the option holder usually pays a premium to purchase the option.)

[REDACTED] has also taken a position analogous to the grantor of a call option with a strike price of \$[REDACTED]. If the Maturity Price of [REDACTED] stock is \$[REDACTED] or greater, [REDACTED] holders will be in a position economically equivalent to holders of a call option on [REDACTED]% of [REDACTED] of [REDACTED] stock for each unit held.

contract as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount." Notional principal contracts include equity swaps. Id. The [REDACTED] units resemble an equity swap of [REDACTED] common stock. They provide for payments at specified intervals and a final payment linked to the value of [REDACTED] common stock.

The [REDACTED] units may also be viewed as prepaid forward contracts, where payment is made at issuance for a promise to deliver property in the future. Here, purchasers paid \$ [REDACTED] in [REDACTED] in exchange for stock (or its cash equivalent) to be delivered in [REDACTED].

The [REDACTED] units may also be viewed as in a class of their own. As such, [REDACTED] would be subject to a unique set of tax rules appropriate for its unique classification.

Under any of these alternative analyses, I.R.C. § 1092(d)(3)(B)(i)(II) would apply, and [REDACTED]'s interest in the [REDACTED] stock would be treated as § 1092 personal property. As a result, [REDACTED]'s position in the [REDACTED] and the [REDACTED] common stock would be a straddle.

Without elaborating much beyond the language of I.R.C. § 1092(d)(3)(B)(III), the applicable regulatory language provides that "personal property includes any stock that is part of a straddle, at least one of the offsetting positions of which is a position with respect to substantially similar or related property (other than stock)." Treas. Reg. § 1.1092(d)-2. Stock and property are treated as substantially similar or related when the values of the stock and property primarily reflect (among other things) a "single firm or enterprise" and it is expected that changes in the value of the stock will approximate (directly or inversely) changes in the value of the property (or a fraction or a multiple of the property). Treas. Reg. §§ 1.246-5(b)(1); 1.1092(d)-2(a).

Changes in the value of the [REDACTED] would approximate changes in the value of [REDACTED] stock. As such, the [REDACTED] units are "substantially similar or related" to the [REDACTED] stock. As previously discussed, [REDACTED]'s position in the [REDACTED] and the [REDACTED] stock are offsetting. Under Treas. Reg. § 1.1092(d)-2, the [REDACTED] and the [REDACTED] stock are parts of a straddle.

- b. [REDACTED] holds the [REDACTED] and [REDACTED] stock as a straddle subject to the capitalization rules of I.R.C.

§ 263(g)

No deduction is allowed for "interest and carrying charges" properly allocable to § 1092 straddle property. I.R.C. § 263(g). For purposes of this disallowance, the term "interest and carrying charges" is the interest on indebtedness used to acquire and carry personal property plus all other amounts paid or incurred to hold the property, less certain amounts as set forth in I.R.C. § 263(g)(2)(B). I.R.C. § 263(g)(2).

We know of no decisions, rulings, or other official pronouncements interpreting the word "carry" as used in § 263(g) for the years at issue. I.R.C. § 265, regarding the treatment of interest and expenses relating to tax exempt income, also uses the word "carry". I.R.C. § 265(a)(2) disallows a deduction for "[i]nterest on indebtedness incurred or continued to purchase or carry" tax exempt obligations.

The clearest case of when an indebtedness "carries" a tax exempt obligation under § 265 occurs when borrowed sums are used for, and are directly traceable to, the purchase or continuation of the tax exempt obligation. See E.F. Hutton Group, Inc. v. United States, 811 F.2d 581 (Fed. Cir. 1981); Bishop v. Commissioner, 342 F.2d 757 (6th Cir. 1965), aff'g 41 T.C. 154 (1963); Jacobson v. Commissioner, 28 T.C. 579 (1957). A second situation (where an indebtedness may be found to carry a tax exempt obligation) occurs when the taxpayer uses its ownership of a tax exempt obligation as collateral for the indebtedness. In substance this "tax exempt property as collateral" situation is the same as the first situation where the indebtedness is used to purchase the tax exempt obligation. See Rev. Proc. 72-18, 1972-1 C.B. 140; Wisconsin Cheeseman v. United States, 388 F.2d 420, 422 (7th Cir. 1968) (the rule denying a deduction for indebtedness carrying a tax-exempt obligation makes no distinction between "one who borrows to buy tax-exempts and one who borrows against tax-exempts already owned").

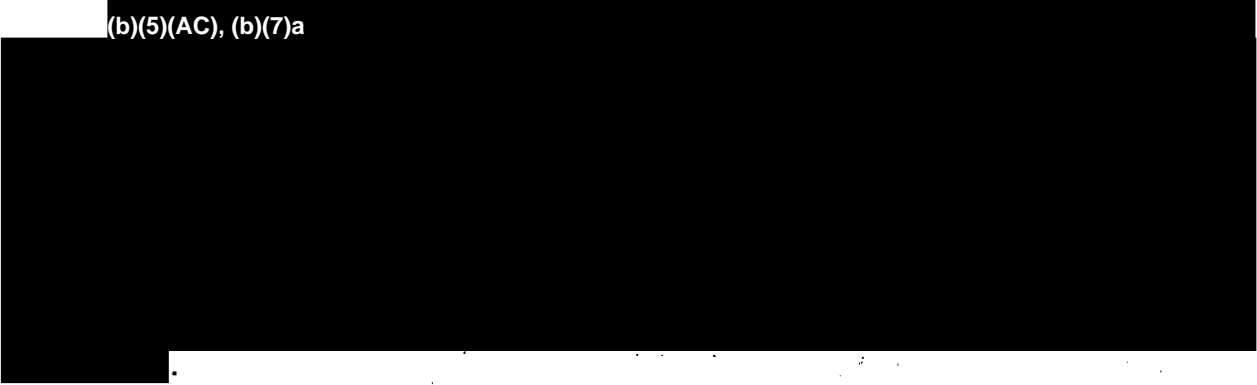
Citing Wisconsin Cheeseman, the Service has said that evidence of indebtedness carrying a tax exempt obligation may also be found in the totality of facts and circumstances establishing "a 'sufficiently direct relationship' between the borrowing and the investment in the tax-exempt obligations." Rev. Proc. 72-18 at § 3.04. The revenue procedure says that a "purpose to carry" a tax exempt obligation may "be inferred where a corporation continues indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities". Rev. Proc. 72-18, at § 6.02, citing Illinois

Terminal Railroad Co. v. United States, 375 F.2d 1016 (Ct. Cl. 1967).

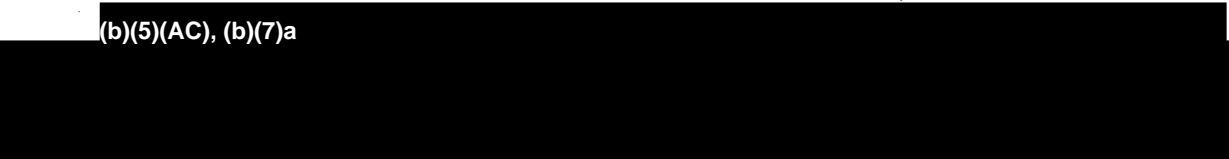
Interpreting the term "carry" in § 263(g) the same as it is used in § 265, we may conclude that [REDACTED]'s quarterly payments to the [REDACTED] holders is a charge that carries [REDACTED]'s holding of [REDACTED] common stock. The quarterly payments are an amount [REDACTED] pays for use of the money it generated from the [REDACTED] issuance. The principal amount of the [REDACTED], issued in [REDACTED], equaled the [REDACTED] closing price of [REDACTED] common stock. [REDACTED] held as many or more shares of [REDACTED] stock as the number of [REDACTED] units issued. At maturity the [REDACTED] holders were to be paid in [REDACTED] stock or the cash equivalent. [REDACTED]'s use of the [REDACTED] stock is similar to a taxpayer who obtains a loan by collateralizing the tax exempt securities it already owns. [REDACTED] could have raised funds by going to a lender, offering the [REDACTED] stock as collateral, and obtaining a loan that approximated the value of the [REDACTED] stock. In obtaining such a loan, the indebtedness would "carry" [REDACTED]'s holding of [REDACTED] stock. Similarly, funds raised by issuance of the [REDACTED] (an alternative to using the stock as collateral for a loan) "carry" [REDACTED]'s holding of [REDACTED] stock.

The [REDACTED] protect [REDACTED] from a decline in value of the [REDACTED] stock, as well as limit the ability of [REDACTED] to gain from an appreciation in the value of the stock. This shows [REDACTED]'s willingness to cede substantial elements of its ownership of the [REDACTED] stock for the funds received at issuance of the [REDACTED]. Issuing the [REDACTED] effectively served as an alternative to selling or borrowing against the [REDACTED] stock.

(b)(5)(AC), (b)(7)a



(b)(5)(AC), (b)(7)a



(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

We are requesting the national office's 10 day post review of this opinion. It is possible that the national office may supplement, revise, or change the advice contained herein. Please do not act on this advice until the national office completes its 10 day review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this matter, please call

Michael Calabrese of this office at (414) 297-4241.

Steven R. Guest
Associate Area Counsel (LMSB),
Chicago

By: _____
MICHAEL J. CALABRESE
Attorney

cc (by e-mail only):

Harmon Dow, Associate Area Counsel (IP), Chicago
Barbara Franklin, Senior Legal Counsel (LMSB), National Office
Rose Gole, Financial Products Industry Counsel, Brooklyn
Steven Guest, Associate Area Counsel (LMSB), Chicago
Thomas Kerrigan, Financial Products Industry Counsel, Brooklyn
James Lanning, Area Counsel (LMSB), Chicago
William Merkle, Associate Area Counsel (SL), Chicago
Mary Truchly, Financial Institutions & Products, Branch 3
Robert Williams, Attorney Advisor, FIP, Branch 3